BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

BOB STUMP, Chairman
GARY PIERCE
BRENDA BURNS
BOB BURNS
SUSAN BITTER SMITH

IN THE MATTER OF THE COMMISSION'S INQUIRY INTO RETAIL ELECTRIC COMPETITION	Docket No. E-00000W-13-0135 **NOTICE OF FILING ELECTRIC COMPETITION COMMENTS OF ARIZONA INVESTMENT COUNCIL**

Notice is given that the Arizona Investment Council ("AIC") has filed its comments in Response to Staff's May 23, 2013 Notice of Inquiry in this Docket.

RESPECTFULLY SUBMITTED this 15th day of July, 2013.

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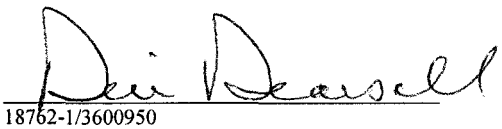

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Arizona Investment Council's Comments on Retail Electric Restructuring (Docket No. E-00000W-13-0135)

The Arizona Investment Council ("AIC"), on behalf of its 6,000 individual members – many of whom are debt and equity investors in Arizona utilities – as well as its utility and corporate members, submits these comments in response to the questions in Staff's May 23, 2013 Notice of Inquiry.

INTRODUCTION

There is no doubt that the risks of moving to a restructured market greatly exceed any potential and, for most customers, the completely nonexistent benefits of moving to retail electric competition. Further, a restructured market that extinguishes the regulatory compact poses exceptional risks for investors who have placed their capital at risk under the rules and restrictions of traditional regulation in our State. That's not simply AIC's analysis; it is the demonstrated results of electric deregulation to date. Restructured markets in the relatively few states which have chosen that course have repeatedly failed to meet expectations for lower prices and better service for all customers; have failed in most venues to attract large numbers of residential and small business customers to competitive providers; have not provided sufficient incentives to construct new and needed generation capacity and resource diversity; and continue to require close monitoring to guard against market manipulation and other aberrant practices.

The AIC submits that the most relevant question to be posed in this inquiry is:

> Why is it that 20 years after California's "Blue Book" theoretically charted the correct course to retail competition, only 14 of the 50 states have a fully active market; 29 states have never authorized it; and seven states have rejected or repealed competition?

Succinctly stated, market restructuring, or retail electric competition, is simply not in our State's public interest. Arizona's traditional model of utility regulation should remain in place. It has produced stable rates for customers; fostered the introduction of innovative services and products, including creative rate designs, energy efficiency programs and renewable sources of power; and, most importantly, provided safe, adequate and reliable service for all customer classes. Capital markets have taken notice of Arizona's stable and improving regulatory climate – enabling utilities to attract capital at favorable rates and terms for the infrastructure needed to serve Arizona consumers and businesses. A restructure to retail competition will unravel this progress and introduce high levels of risk and uncertainty for consumers and investors alike.

In fact, just the announcement by the Commission of its restructuring inquiry, together with the May 23 Letter of Inquiry, have already led to a credit rating downgrade for UNS Energy and confusion among analysts. "Clear as Mud" was the headline in one analyst's report of June 20, 2013 describing the Commission's consideration of restructuring and the reasons for the UNS rating downgrade ("UNS Energy Corp., Downgrade to Hold; Arizona Regulation Clear as Mud," June 20, 2013). That same day, UNS Energy's stock price dropped by 5.5 percent – a loss of $200 million of market value in a single trading session.

The Commission should forego yet one more attempted restructuring of Arizona's electric industry for the following reasons:

- Arizona's last market restructuring was expensive, complex and contentious. It was discontinued because of market dysfunctions as well as practical and legal issues, which have not been and likely cannot be satisfactorily resolved to make restructuring even workable for – much less attractive to – most consumers.

- A move to a competitive retail power market in Arizona creates great uncertainty in planning future resources; renders integrated resource planning useless; threatens reliability; and jeopardizes investment in necessary generating assets. This problem currently faces Texas, where the retail market was deregulated and which is in danger of blackouts for the second straight summer.

- Introduction of retail competition requires that investor-owned utilities and their investors be adequately compensated for investments that are stranded or uneconomic in a competitive environment, i.e., the renewables investments mandated for the past several years. The burden of paying for these stranded investments will fall on customers; further, designing and implementing mechanisms to recover these costs will be complex and contentious.

- The potential beneficiaries of market restructuring are (1) large customers and (2) new competitive entrants who will target these most profitable customers. Residential and small business customers are unlikely to participate and, more likely, will experience rate increases to pay for stranded investments and other programs to implement competition. Expectations of lower prices and better service for all customers simply have not materialized in the minority of states which have restructured.

- Moving to competition in electricity does not eliminate regulation but, instead, requires new forms of regulation. Thus, the ACC must accept additional regulatory responsibilities to protect residential and small business customers in a competitive market and develop new methods of regulation, oversight and consumer education. All of this will be complex and costly. Further, competitive providers must be required to meet the same regulatory standards, such as renewables, energy efficiency and resource planning, that incumbents are required to meet.

One need only examine the tortured history of Arizona's first attempt at electric competition to get a firm indication of how complex, difficult and expensive restructuring will be. Even if the daunting regulatory, economic and political risks of deregulation could somehow be mitigated, Arizona's Constitution does not permit a competitive market to set prices – the essential tenet of a truly competitive marketplace.

Almost 20 years ago and after having spent two years studying the issue of deregulation and conducting meetings and workshops involving a multitude of participants and stakeholders, the initial rules establishing a restructured market were adopted by the Commission in December of 1996. Over the next four years, more meetings and workshops were held to consider modifications to the rules. To overcome a variety of infirmities, pitfalls and overlooked issues, the rules were amended further three times in 1998 (Decisions Nos. 60977, 61071, 61272); three more times in 1999 (Decision Nos. 61311, 61677, 61969); and again in 2000 (Decision No. 62924). Still, these seven revisions and extensive efforts failed to perfect the rules and avoid litigation.

But, in the midst of Arizona's search for a deregulation formula, the meltdown of California's electricity market in 2000-2001 served as a cautionary jolt for Arizona regulators. Deregulation in California brought rolling blackouts; wildly escalating, by tenfold, wholesale power prices; the bankruptcy of one California utility; the near bankruptcy of another; and previously unheard-of, significant increases in retail electricity rates. It also fueled the recall of the Governor of California.

On the heels of that disaster, the Commission, in 2002, wisely reversed a major condition of the deregulation experiment and cancelled its requirements that Arizona investor-owned utilities (1) divest themselves of generating assets and (2) purchase all their power in the competitive market (Decision No. 65154).

In 2004, the Arizona Court of Appeals put the final stake through the heart of Arizona's restructuring effort by, *inter alia*, invalidating several of the ACC's rules as well as all of the CC&Ns for competitive providers and declaring market-determined rates to be unconstitutional.

From 1994 through 2004, the Commission, the utility companies and stakeholders spent thousands of hours and millions of dollars studying and preparing for deregulation. Docket Control (No. 94-0165) is the repository of several hundred filings by utilities, other stakeholders and interested parties attesting to the complexity and contentiousness of implementing, then unwinding Arizona's competitive model. Utility companies collectively spent some $100 million in making changes to IT systems and customers began paying for the costs of stranded investments in anticipation of deregulation. Today, those rules – which were amended seven times – are essentially useless and the IT changes – which were shelved when the Commission pulled back on competition – are now obsolete and must be re-done at even greater cost.

In the meantime, under the traditional regulation model, Arizona consumers have continued to enjoy fairly stable electric rates. The ACC has carefully evaluated rate requests and kept rate increases at minimum levels. Additionally, Arizona's regulated utility model has continued to meet demand in Arizona's harsh climate at reasonable prices and has avoided insufficient capacity issues created by market uncertainties in deregulated states such as Texas. The Commission's measured regulatory approach has improved the financial health of investor-owned utilities; led to improved credit ratings; and provided opportunities to attract capital on the best rates and terms – all of which have assured reliable power to all customer classes at the lowest, reasonable rates.

Today – after some 20 years of pondering the concept – a fully active competitive electric market is used in only 14 states. Twenty-nine states have never authorized competition; and seven states have rejected or repealed competition.[1]

Proponents of deregulation argue that much has changed over the past two decades to improve the functionality of open electric markets. They cite success stories in a few states, like Texas, that have chosen to deregulate. However, the models in place elsewhere have failed to meet the lower price and rate expectations envisioned when first implemented. They have also introduced system reliability risks, because they actively discourage investment in new generating assets. Further, customers in Illinois and Maryland experienced hefty rate shock once price caps imposed during the transition to full competition were lifted. In Maryland, that fallout led to the removal of all five public service commissioners from office.

Additionally, residential customers have been consistently promised the "benefit" of choice among an array of providers and service offerings. Yet, in most states that have introduced competition (Texas is the exception), a relatively small percentage of residential customers have switched to competitive providers. Despite spending several hundred million dollars on customer education programs, less than one-third of residential customers in Pennsylvania have switched to a competitive provider; in

[1] Energy Information Administration, "Status of Electricity Restructuring by State," September 2010.

Maryland, only 22 percent have switched providers; and in New Jersey, 14 percent of residential customers have switched.[2] In New York, groups like the AARP are warning the public it needs to be extremely careful before leaving utilities for alternative suppliers. It says promised savings often do not materialize.[3]

Additionally, notwithstanding the best efforts of independent system operators to ensure a truly competitively priced flow of wholesale power, market power abuse and manipulation potential by wholesale energy traders has not been extinguished. In 2012, the Federal Energy Regulatory Commission settled its charges of power market manipulation against Constellation Energy Commodities Group, Inc. for $245 million – consisting of a $135 million fine and $110 million in disgorged profits. According to its website, the FERC has issued $172 million in fines since 2007, excluding the Constellation fine.

In a deregulated electricity market, these kinds of problems and imperfections will persist as long as energy marketers and traders seek every advantage and opportunity to maximize profits. The need for Arizona regulatory monitoring and enforcement will be great. Somewhat ironically, in the relatively few states that have moved to competition, federal and state regulators have actually added more layers of protective regulations, not less, as one might expect with competitive markets.

The Commission should ask itself what has changed since it, more than a decade ago, reversed course so as to now require that it re-examine restructuring. In truth, nothing has changed other than what may be a short-term opportunity afforded natural gas merchant plant operators – both in- and out-of-state – to market lower cost power from natural gas to large industrial and commercial customers.

That's a transitory, obviously insufficient reason to overturn a system that has for decades provided all customers with safe, adequate and reliable service at reasonable rates. It's not in the public's interest to exchange the current regulatory system for another form of regulation that will be enormously expensive to implement; will impose new costs on utility companies and their other customers; will produce uncertain, likely short-term benefits to a few select customers; and will create new regulatory burdens attempting to protect vulnerable customers and police the competitive market.

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[2] "2012 ABACCUS: An Assessment of Restructured Electricity Markets," Annual Baseline Assessment of Choice in Canada and the United States, December 2012.

[3] October 3, 2012; "**Choice offers higher cost**"; *Tribune Regional News.*

AIC'S RESPONSE TO THE COMMISSION'S 18 QUESTIONS

Q1. Will retail electric competition reduce rates for all classes of customers – residential, small business, large business and industrial classes?

A1. No. If the Commission decides to transition the market to competition, it must also ensure that regulated utilities and their investors are compensated for investments in assets that are uneconomic in the changed paradigm, but which are used, useful and required to serve customers under the traditional utility model. The result will be rate increases for customers.

Additionally, experience in the dozen or so states that have moved to competition shows that customer rates generally follow fuel costs which, until quite recently, have increased and driven higher rates. There is nothing inherent in the competitive model that assures prices will fall for all or that the price of natural gas will remain low into the future. When the price of natural gas increases (and it will), spot prices will increase and produce, in turn, an increase in retail prices.

Q2. In addition to the possibility of reduced rates, identify any and all specific benefits of retail electric competition for each customer class.

A2. The alleged benefit to customers from competition is the opportunity to choose among alternative providers assuming, of course, the selected provider is willing to serve that customer. In Texas, for example, customers in large cities like Houston and Dallas can choose from upwards of 40 providers offering 250 alternative products and rate designs/schedules. For smaller customers, however, making the "correct" choice from this multitude of options can be confusing, burdensome, daunting and dangerous. Telemarketers selling offerings in competitive electricity markets can be both intrusive and intimidating. Should the Commission elect this course, it will need to oversee an aggressive consumer education and policing program to aid customer selections and protect against unscrupulous practices.

Although proponents of competition cite to increased innovation and efficiency driven by competitive forces, there is no evidence that innovation and efficiency increase more rapidly under competition than under traditional utility regulation. Further, Arizona investor-owned utilities operating under the current model have kept pace in electricity innovation, technology, efficiency and rate design and have provided award-winning service to their customers at reasonable prices overseen by the ACC.

Q3. How can the benefits of competition apply to all customer classes equally or equitably?

A3. It's not possible. Under competition, there will be winners and losers – that's how competitive markets work. Not all customers will benefit equally. The ability to shop for power, for example, does not extend equally among the customer classes. Large customers – experienced in electricity markets throughout the country – have a much greater opportunity to benefit from competition. Residential and small business customers generally lack sufficient interest, time, information, knowledge and expertise to take advantage, if even possible, of competition. Furthermore, competitive providers will understandably focus their marketing efforts on the most profitable customers, i.e., large consumers of power at high load factors.

Q4. Please identify the risks of retail electric competition to residential ratepayers and to the other customer classes. What entity, if any, would be the provider of last resort?

A4. *See* prior answers. All customer classes, including residential, would be vulnerable to fluctuations in fuel prices, especially changes in natural gas prices, which have experienced often radical and sudden changes over the past decade. Further, competition may discourage or retard the process of bringing online sufficient generating resources to meet demand, thus jeopardizing system reliability and service. Integrated resource planning would be difficult, if not impossible, to conduct. The Commission's mandated programs for energy efficiency and renewables, which many customers view as beneficial, would also be jeopardized.

The normal model of "provider of last resort" makes incumbent utilities serve that role. However, among a myriad of other complexities, new rate mechanisms must be constructed to ensure recovery of fixed and stranded costs as customers leave the traditional provider, then return to that provider when they are not adequately served by competitors.

Q5. How can the Commission guarantee that there would be no market structure abuses and/or market manipulation in the transition to and implementation of retail electric competition?

A5. It can't. More than a decade after the lessons of California, last year, the FERC imposed a $135 million civil penalty on Constellation Energy Commodities Group, Inc. for alleged market manipulation regarding transactions in the Northeast. It is unlikely the Commission or any agency can ensure that manipulative or other abusive practices don't occur.

The FERC likely will play a major role in ensuring against fraudulent trading practices in Arizona. In that process, the Commission will cede much of its regulatory oversight to the federal government.

Q6. What, if any, features, entities or mechanisms must be in place in order for there to be an effective and efficient market structure for retail electric competition? How long would it take to implement these features, entities or mechanisms?

A6. Some of the primary features, entities or mechanisms necessary for effective and efficient retail competition include:

- A robust competitive wholesale market that operates in an open, fair and transparent manner.
- An Independent System Operator or Regional Transmission Organization to coordinate wholesale power sales and purchases and delivery of electricity over the grid. The ISO and/or RTO must accommodate transactions beyond Arizona's border to take advantage of regional load diversity. It also must be provided enforcement authority to ensure fair, open and transparent transactions and to punish violators in concert with FERC.
- A consumer education program to ensure residential and small business customers have sufficient knowledge and information to participate as consumers in a competitive electricity market.
- Competitive rules that meet all Arizona legal and constitutional requirements.
- A mechanism to ensure utility companies and investors are fairly compensated for investments made under traditional regulation that are left uneconomic or stranded in a competitive environment.

How long will this take? Implementing the requirements for a competitive market and any additional regulatory oversight requirements will take a minimum of two years and could take the six years it did in the late 1990s to early 2000s before being cancelled. The issues are difficult and the stakes are high for all concerned.

Q7. Will retail electric competition require divestiture of generation assets by regulated electric utilities? How would FERC regulation of these facilities be affected?

A7. AIC believes many different competitive models might be attempted with or without divestiture and defers a more definitive response on this subject to the utilities filing comments.

Q8. What are the costs of the transition to retail electric competition, how should those costs be quantified and who should bear them?

A8. Costs include, but are not limited to:

- IT investments and operational costs related to changing billing systems to accommodate competition.
- Costs of establishing or joining an Independent System Operator or Regional Transmission Organization.
- Costs associated with recovery of stranded investments.
- Costs of designing and implementing customer education programs.

How to quantify:

- The utility companies should provide cost proposals for evaluation, comment and input by the Commission and stakeholders.

Who should bear these costs:

- Customers and competitive entrants.

Q9. Will retail electric competition impact reliability? Why, or why not?

A9. Competition will likely have an adverse effect on reliability. Major reasons are that generating companies are reluctant to bring new generating sources of power to market in a competitive situation because, *inter alia*, competition creates uncertainty regarding customer sales and cost recovery of these capital-intensive, long-lived assets and new supply reduces market prices and profits. This is what has happened, *inter alia*, in Texas.

Q10. What are the issues relating to balancing area authorities, transmission planning and control areas which must be addressed as part of a transition to retail electric competition?

A10. AIC believes answers to this question involve technical matters best explained by the utilities.

Q11. Among the states that have transitioned to retail electric competition, which model best promotes the public interest for Arizonans? Which model should be avoided?

A11. Each state in which restructuring has occurred has tailored its competitive model to meet its unique requirements and needs as well as geographic, resource and other factors or constraints. Therefore, should the Commission decide to proceed with competition, it must first identify Arizona's unique needs, requirements and constraints as well as competitive expectations. Arizona's model should be based on that requirements analysis. Additionally, the Commission should be prepared to make continual adjustments as problems, difficulties and imperfections arise – just as they did from 1996-2002.

Q12. How have retail rates been affected in states that have implemented retail electric competition?

A12. The most recent American Public Power Association ("APPA") study on this subject shows increases in retail electric prices for 15 years between 1997 and 2012 have been consistently higher in states with deregulated markets than in regulated states (American Public Power Association, "Retail Electric Rates in Deregulated and Regulated States: 2012 Update," April 2013). According to the APPA study: "[D]eregulated states [are now] paying, on average, rates that are 3.0 cents per kWh above rates in regulated states (11.9 v. 8.9)."

Q13. Is retail electric competition viable in Arizona in light of the Court of Appeals decision in *Phelps Dodge Corp. v. Ariz. Elec. Power Coop.*, . . . Are there other legal impediments to the transition to and/or implementation of retail competition?

A13. The AIC joins the legal analysis in response to this question which is attached as Exhibit A to the comments of the Grand Canyon State Electric Cooperative Association ("GCSECA") and which is also attached hereto as Exhibit A.

Q14. Is retail electric competition compatible with the Commission's Renewable Energy Standard that requires Arizona's utilities serve at least 15% of their retail loads with renewable energy by 2025?

A14. No. Moving to competition means the market will determine the correct sources and mixes of electricity based primarily on price, supply and demand. It is antithetical to the competitive model that government require electricity to be produced by specific means, especially when the costs of production from a preferred source are greater than costs of alternative sources. Further, it would be unfair and a severe handicap to continue to require Arizona utility companies to meet this standard, while allowing new entrants to avoid compliance at the same level and on the same terms and conditions. Thus, any regulatory mandates of this nature, if imposed, should apply equally to incumbents and new entrants.

Q15. Is retail electric competition compatible with the Commission's Energy Efficiency Standard that requires Arizona's utilities to achieve a 22% reduction in retail energy sales by consumption by 2020?

A15. No. *See* the response to Q14.

Q16. How should the Commission address net metering rates in a competitive market?

A16. AIC defers to the responses of the utilities on this subject.

Q17. What impact will retail electric competition have on resource planning?

A17. Because Arizona utilities will not be able reliably to predict their load requirements in a competitive environment, it is a much more difficult exercise to plan resources for customers who might or might not become or remain customers. Integrated Resource Planning has little meaning in a competitive market and can be argued to be wholly antithetical to competition's necessary constructs.

Q18. How will retail electric competition affect public power utilities, cooperatives and federally controlled transmission systems?

A18. Quite negatively. The AIC refers to the response of the GCSECA on this question.

EXHIBIT A

EXHIBIT A

I. QUESTIONS PRESENTED. (By Item 13 of the Commission's May 23, 2013 Notice of Inquiry. Docket No. E-00000W-13-0135/In the Matter of the Commission's Inquiry into Retail Electric Competition.)

1. Is retail electric competition viable in Arizona in light of the Court of Appeals' decision in *Phelps Dodge Corp. v. Ariz. Elec. Power Coop.*, 207 Ariz. 95, 83 P.3d 573 (App. 2004)?

2. Are there any other legal impediments to the transition to and/or implementation of retail electric competition?

II. DISCUSSION.

Retail electric competition—where the market, not the Commission, determines rates for competitive services—was declared unconstitutional in *Phelps Dodge v. Ariz. Elec. Power Coop.*, 207 Ariz. 95, 83 P.3d 573 (App. 2004). Further, there are many more legal impediments to the transition to and/or implementation of retail electric competition.[1] Each of these roadblocks will be discussed below. It is important to view them within the confines of the following limitations on the Commission's powers and rulemaking authority:

- "The Commission does not possess any inherent powers...but instead exclusively derives its power from the constitution and the legislature." *Phelps Dodge*, 207 Ariz. at 111, ¶ 54, 83 P.3d at 589 (citing *Williams v. Pipe Trades Indus. Program*, 100 Ariz. 14, 17, 409 P.2d 720, 722 (1966); *US West Communications, Inc. v. Arizona Corp. Com'n*, 197 Ariz. 16, 23, ¶ 29, 3 P.3d 936, 943 (App. 1999) ("US West I")).

- "Article 15, Section 3 [of the Arizona Constitution] not only empowers the Commission to set just and reasonable rates, it *requires* the Commission to do so." *Id.* at 107, ¶ 32, 83 P.3d at 585 (emphasis added); *see also* Ariz. Const. art. XV, § 3 ("The corporation commission shall have full power to, *and shall*, prescribe...just and reasonable rates and charges to be made and collected by public service corporations within the state for service rendered therein...") (emphasis added).

- In fulfilling its obligations under Article XV, Section 3, the Commission must "consider[] the needs of all whose interests are involved, including public service corporations and the consuming public." Id. at 128, ¶ 153, 83 P.3d at 606.

[1] This memo focuses on a variety of legal impediments to, and problems with, the *concept* of retail electric competition in Arizona. If, in the future, the Commission promulgates new retail electric competition rules, additional legal issues will become apparent in relation to whatever model is proposed. The existing rules are invalid for several reasons, i.e., certain provisions have been declared unlawful or unconstitutional; others are invalid for failure to submit for Attorney General review; and the remainder are non-compliant in relation to Administrative Procedure Act requirements.

- The Arizona Supreme Court has interpreted the Commission's power to "supervise and regulate" public service corporations under A.R.S. § 40-202(A) as "bestowing no power on the Commission beyond that already provided by the constitution or specifically granted otherwise by the legislature." *Id.* at 112, ¶ 58, 83 P.3d at 590 (citing *Southern Pac. Co. v Arizona Corp Com'n.*, 98 Ariz. 339, 348, 404 P.2d 692, 698 (1965) ("The right to supervise and regulate and do those things necessary and convenient in the exercise of [the Commission's] power of supervision and regulation [of public service corporations] does not in and of itself grant additional powers to the Commission beyond that which the legislature specifically has set forth.")).

- Finally, Arizona courts will not infer the grant of Commission authority "beyond the clear letter of the [Arizona Constitution or] statute." *Id.* at 113, ¶ 59, 83 P.3d at 591 (citing *Southern Pac. Co.*, 98 Ariz. at 343, 404 P.2d at 695).

A. Retail Electric Competition is Not Viable in Light of the Court of Appeals' Decision in *Phelps Dodge*.

In *Phelps Dodge*, the Court of Appeals evaluated whether the Commission properly approved the entry of competitive electric service providers into the Arizona market and ruled on a variety of constitutional, statutory and administrative challenges to Retail Electric Competition rules set forth in A.A.C. R14-2-1601 to R14-2-1616 (the "Rules"). There are key holdings in *Phelps Dodge* which are antithetical to retail electric competition in Arizona.

1. The Commission is Required to Set Just and Reasonable Rates by Finding and Using Fair Value.

Article XV, Section 3 of the Arizona Constitution "*requires* the Commission to 'prescribe...just and reasonable rates and charges to be made and collected by public service corporations,'" which includes all electric public service corporations ("PSCs") and potential competitive electric service providers ("ESPs"). *Phelps Dodge*, 207 Ariz. at 103-104, ¶ 18, 83 P.3d at 581-82. Further, Article XV, Section 14 of the Arizona Constitution requires the Commission to ascertain the fair value of the property of every public service corporation doing business in Arizona "[t]o assist the Commission in the 'proper discharge of its duties.'" *Id.* at 104, ¶ 18, 83 P.3d at 582. The Court stated that the Constitution "*requires* the Commission to determine the fair value of property owned by the ESPs in Arizona *and* consider that finding in setting rates." *Id.* at 105, ¶ 23, 83 P.3d at 583 (emphasis added). Further, it stressed that the Commission *cannot* "simply engage in a futile exercise of determining fair value and then completely ignore its findings." *Id.* at 106, ¶ 26, 83 P.3d at 584. Rather, "fair-value

determinations *must* be used to aid the Commission . . . in setting rates" for all Public Service Corporations ("PSCs"), including competitive Electric Service Providers ("ESPs"). *Id.* (emphasis added).[2]

Given that holding, retail electric competition cannot be implemented in Arizona, because fair value ratemaking is inherently antithetical to the concept of rates established by a competitive market. That fact is readily apparent in the requests of ESP applicants currently filed in the Commission's Docket Control.

For example, Direct Energy's pending application (Docket No. 13-0126) specifies the formula to be used in calculating the rates to be charged for its services. Its rates' formula gives *no* consideration to the fair value of Direct Energy's property. *See* Direct Energy's Application at p. 3, Appx. C and D. It specifies rates for non-residential and residential services which are (i) not less than Direct Energy's marginal cost of providing the service and (ii) not more than the specific price index or generation rate of the customer's applicable retail schedule in effect on the date the ESA is executed plus 35%. The applications submitted by PDM Energy and Constellation NewEnergy are similarly flawed.[3] Allowing ESPs to set their own rates using this or similar formulas contravenes the Commission's responsibilities to find and *use* fair value in establishing just and reasonable rates.

2. The Commission's Ratemaking Duties Are Not Satisfied by Setting a *Broad* Range of Rates Within Which the Competitive Marketplace Can Operate.

The *Phelps Dodge* Court acknowledged that the Commission can establish a *just and reasonable* range of rates within which an ESP and consumer can negotiate the precise rate to be charged for electric service. *See Phelps Dodge*, 207 Ariz. at 109, ¶ 44, 83 P.3d at 587. However, the Court rejected "the Commission's contention that its approval of a *broad* [or open-ended] range of rates within which the competitive marketplace can operate satisfies the Commission's obligation to set just and reasonable rates." *Id.* at 107, ¶ 33, 83 P.3d at 585 (emphasis supplied).

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[2] *See also US West I*, 198 Ariz. at 217, ¶ 25, 8 P.3d at 405 ("We hold that the Arizona Constitution requires the Commission to determine a fair value rate base for all public service corporations before setting rates, unless and until the fair value determination requirement contained in article 15, section 14, is amended by the people of this state."); *US West II*, 201 Ariz. at 246, ¶¶ 21-24, 34 P.3d at 355 (recognizing that "the commission is constitutionally required to ascertain the fair value of the [ESPs'] Arizona property," and emphasizing the importance of the fair-value finding "in determining and avoiding the harsh extremes of the rate spectrum.").

[3] PDM Energy's Application, Docket No. 06-0470 at p. 2, Attachment A (specifying a "market based energy charge, as negotiated, not to exceed on an average monthly basis *$6 per kilowatt-hour* for a fixed energy price or as the adder to a *variable index price*, developed upon customer's historical load and historical load patterns. (Emphasis added.) It further provides that electricity and demand charges will "likewise be established through negotiation."). *See also* Constellation NewEnergy's Application, Docket No. 12-0115 at 3, Appx. D and E (specifying a formula virtually identical to Direct Energy's based on a variable price index or generation rate of the applicable retail schedule in effect on the date of execution of the ESA plus 35%).

The Court reasoned that the Commission cannot abdicate its constitutional responsibilities to set just and reasonable rates by allowing competitive market forces to determine those rates instead. *Id.* at 107, ¶ 32, 83 P.3d at 585. "Once an ESP is established in the market, it may increase its rates within the approved [broad] range without regard to consumer fairness or a fair return, possibly banking on some consumers' natural reluctance to constantly monitor rates, discover abuses, and then switch services." *Id.* at 107, ¶ 34, 83 P.3d at 585. "The constitution charges the Commission, *not* consumers themselves, with the duty to discover and remedy such potential overarching by public service corporations." *Id.*

The foregoing is significant when compared to the ranges of rates proposed, for example, by Direct Energy, PDM Energy and Constellation NewEnergy. All of them are contrary to the Court's clear prohibition against setting a broad or open-ended range of rates within which the competitive marketplace can operate. *See* Section II(A)(1), *supra*. Each has asked the Commission to approve an open-ended range of rates, the low end of which is based on the entity's unknown marginal cost, and the high end of which is calculated with reference either to an unknown, variable market-determined index or a very high dollar cap. The *Phelps Dodge* Court specifically rejected a substantially similar scheme, stating:

> The potential for overreaching [by ESPs] is exemplified by the Commission's approval of a wide range of rates that PG & E may charge consumers. In accordance with the Rules, the Commission authorized PG & E to charge consumers a negotiated, market-based rate that is not less than PG & E's marginal cost nor greater than $25 per kilowatt hour. The Commission did not ascertain PG & E's marginal cost. Additionally, at the time the Commission set the maximum rate, the average price of electricity was 3 cents to 5 cents per kilowatt hour. Thus, any rate PG & E can negotiate between its unknown marginal cost and a rate that is roughly 500 to 830 times the average price of electricity, regardless of fairness to the consumer, its impact on an Affected Utility, or whether the rate provides a fair return, is deemed "just and reasonable." *The potential for abuse in pricing within this virtually unrestricted range of rates is apparent and can only be avoided by having the Commission, rather than the market alone, set just and reasonable rates.*

Id. at 108, ¶ 35, 83 P.3d at 586 (emphasis added).

While PDM's $6 per kilowatt hour is less than PG&E's $25/kWh, it certainly qualifies as another example of "potential abuse in pricing," which the *Phelps Dodge* decision condemns. To put that 6 *dollars* per kWh retail price cap flexibility in context, from July 2012 through June 2013 at the Palo Verde hub, the wholesale maximum monthly average on peak price was 3.5 *cents* per kWh. With the $6/kWh tariff "cap," that gives PJM more than 171 times its wholesale cost in retail pricing flexibility.

Moreover, "[b]y exclusively allowing the market to set the ESP's rates, the Commission also abdicates its responsibility to ensure that such rates are fair to the ESPs...[because] [a]n ESP may set its rates low in order to attract customers, possibly denying itself a fair return and

causing it to cut costs or raise charges elsewhere to compensate." *Id.* at 108, ¶ 37, 83 P.3d at 586. "Such measures could potentially affect service to the detriment of the consuming public." *Id.*

There's clearly a potential for abuse and a host of other problems associated with the unrestricted, variable, market-determined ranges of rates proposed by prospective ESPs like Direct Energy, PDM Energy and Constellation NewEnergy. *Phelps Dodge* just as obviously prohibits these proposed rates, which begs the question—is there *any* permissible rate or range of rates that would even appeal to a hopeful ESP? And, if so, why hasn't a hopeful ESP submitted an application that proposes a permissible rate or range of rates?

The reason no such filing has been made is the rates' flexibility necessary for retail electric competition is *inherently* inconsistent, *inter alia*, with the Commission's constitutional obligation to set just and reasonable rates.

Retail electric competition simply is not viable in Arizona in light of the Court of Appeals' decision in *Phelps Dodge*.

B. Other Legal Impediments to Retail Electric Competition in Arizona.

There are several additional impediments to transitioning to and/or implementing retail electric competition in Arizona. Absent a proposed set of rules, it is impossible to outline definitively all of the potential pitfalls, hazards and road blocks. However, we can offer the following observations.

1. Electric Service Providers Cannot Charge Discriminatory Rates.

Implementing retail electric competition in Arizona would violate various constitutional and statutory anti-discrimination provisions by enabling ESPs to charge different rates to similarly situated customers.

Article XV, Section 12 of the Arizona Constitution states: "All charges made for service rendered, or to be rendered, by public service corporations within this state shall be just and reasonable, and *no discrimination in charges, service, or facilities shall be made between persons or places for rendering a like and contemporaneous service*." Similarly, A.R.S. § 40-334 states: "A public service corporation shall not, as to rates, charges...or in any other respect, make or grant any preference or advantage to any person or subject any person to any prejudice or disadvantage...No public service corporation shall establish or maintain any unreasonable difference as to rates, charges...or in any other respect...between classes of services."

The Arizona Supreme Court has recognized that the "law on discrimination as applied to public service corporations generally is well settled." *Town of Wickenburg v. Sabin*, 68 Ariz. 75, 77, 200 P.2d 342, 343 (1948).

> The charges must be equal to all for the same service under like circumstances. A public service corporation is impressed with the obligation of furnishing its service to each patron at the same price it makes to every other patron for the same or substantially the same or similar service. It must be equal in its dealings with all. It must treat the members of the general public alike. All patrons of the same class are entitled to the same service on equal terms. The law will not and cannot tolerate discrimination in the charges.

Id. at 77-78, 200 P.2d 342, 343-44 (citations and internal quotations omitted).

As explained above, ESP hopefuls are seeking to implement rates that necessarily will vary from one customer to the next based on the market index price *in effect on the date of execution of a particular agreement.* These ever-changing indices enable ESPs to charge similarly situated customers different rates based solely upon the respective dates those customers elected to receive service from the ESP. In other words, they allow ESPs to charge discriminatory rates in violation of settled law. Further, either ESP or self-aggregation of differently situated customer groups into common purchasing classes violates statutory and constitutional discrimination prohibitions.

2. The Implementation of Retail Electric Competition Will Interfere With the Commission's Jurisdiction and Authority Over Electric Service in Arizona.

In order to preserve its own jurisdiction and authority over electric service, the Commission should refrain from transitioning to or implementing retail electric service in Arizona. Under the Federal Power Act (the "Act"), the FERC has broad jurisdiction and authority to regulate electric utility companies engaged in interstate commerce. *See* 16 U.S.C.A. §§ 824, *et seq.* For example:

- The Act contemplates that FERC, "in the exercise of its broad regulatory powers, may determine coverage of the Act . . . [and] issue such orders, rules and regulations as it may find necessary or appropriate to carry out the provisions of the Act." *Federal Power Commission v. Arizona Edison Co.*, 194 F.2d 679, 684 (9th Cir. 1952).

- FERC is charged with provid[ing] "effective federal regulation of the expanding business of transmitting and selling electric power in interstate commerce." *New York v. F.E.R.C.*, 535 U.S. 1, 6 (2002).

- FERC's jurisdiction "includ[es] the transmission of electric energy in interstate commerce and the sale of electric energy at wholesale in interstate commerce." *Id.* at 6-7 (internal quotations omitted).

- And, FERC has authority to "correct unlawful practices" of "unreasonable rates and undue discrimination with respect to any transmission sale subject to [FERC's] jurisdiction." *Id.* at 7 (internal quotations omitted).

- The United States Supreme Court agreed with FERC "that transmissions on the interconnected national grids constitute transmissions in interstate commerce," *id.* at 16, and that FERC has "jurisdiction over the transmission of electric energy in interstate commerce...[including] jurisdiction over both wholesale *and* retail transmissions," *id.* at 15 and 18-19 (emphasis added). The Court reasoned that, "[b]ecause the FPA authorizes FERCs jurisdiction over interstate transmissions, without regard to whether the transmissions are sold to a reseller or directly to a consumer, FERC's exercise of this power is valid." *Id.* at 20.

- And, FERC has jurisdiction and authority to investigate alleged discrimination in the *retail electricity market*, "make findings concerning undue discrimination in the *retail electricity market*," and is even *required to* "provide a remedy for that discrimination." *Id.* at 27 (emphasis added) (citing 16 U.S.C. § 824e(a)).

Based on the foregoing, if the Commission decides to implement retail electric competition, it must be prepared to surrender much of its own jurisdiction and authority over the transmission of electricity to Arizona customers, including at least some of its currently exclusive and plenary ratemaking authority.

3. Finally, We Offer the Following Non-Exhaustive Comments on Additional Legal Impediments to the Introduction of Retail Competition in Arizona:[4]

- The *Phelps Dodge* Court held that utilities cannot be compelled to join an organization like an RTO, i.e., in that case, the Arizona Independent Scheduling Administrator. No state has restructured without an operational RTO in place.

- Another impediment related to the unconstitutionality of market-determined rates and price discrimination prohibitions is the separate statutory requirement (A.R.S. § 40-367) that rates be on file with the Commission and open to public inspection. Competitive providers must be required to file and disclose the various and different "deals" actually given to customers.

- The current rules violate the equal protection provisions of the 14th Amendment to the United States Constitution and Article II, Section 13 of the Arizona Constitution in that they do not provide equal treatment of all electric utilities and electric service providers in Arizona.

- The current rules also impermissibly interfere with the internal management and operations of utilities.

[4] The Cooperatives reserve the right to raise additional legal issues and objections if and as this inquiry proceeds.